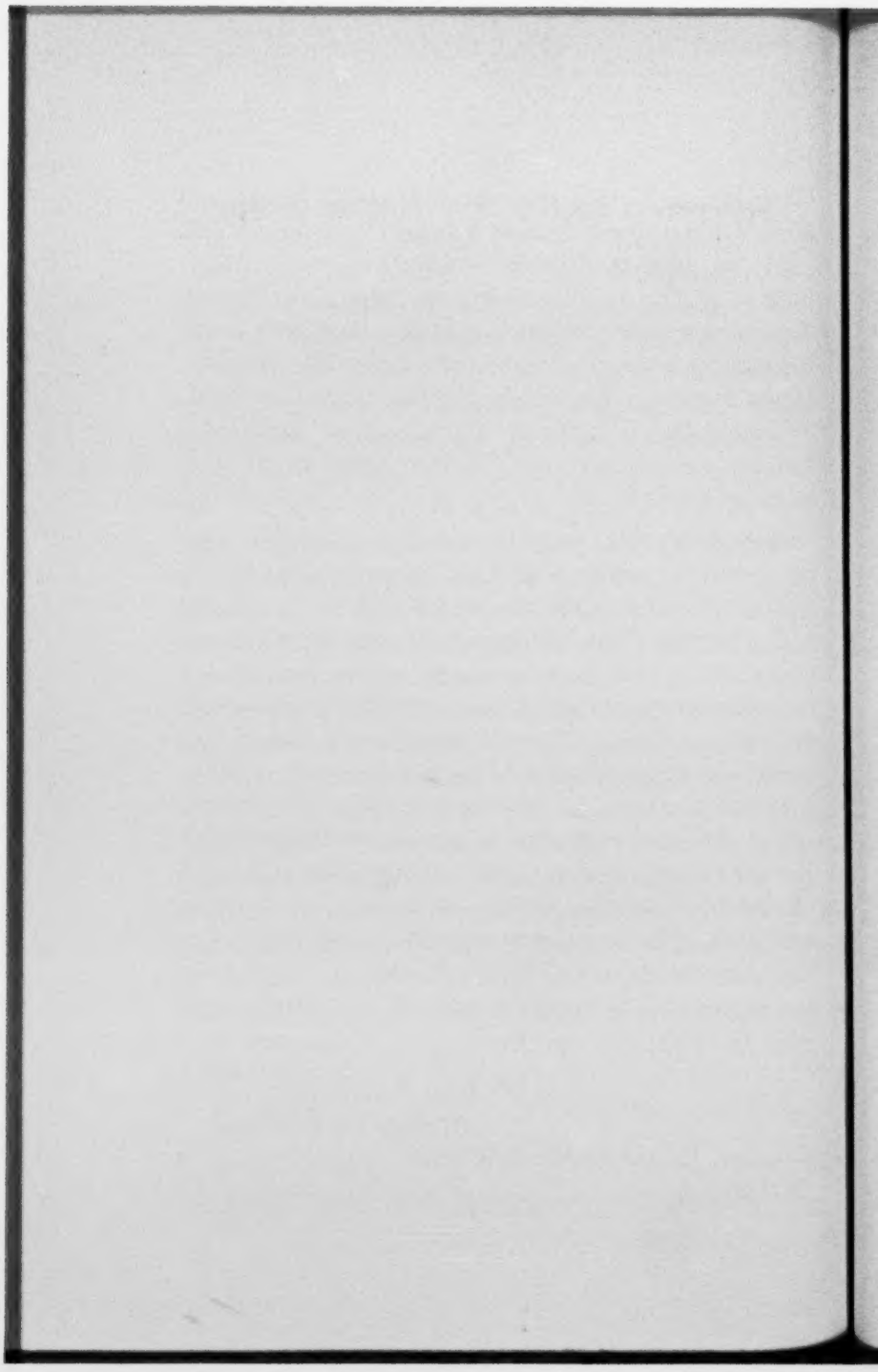

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No.....

FARMERS & GINNERS COTTON OIL COMPANY,
Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

I

The Opinions Below

The opinion of the Board of Tax Appeals is reported in 41 B. T. A. 1083 and is found at page 35 of the Record. The opinion of the Circuit Court of Appeals is reported in 120 F. (2d) 772 (Adv. Sheets) and is found at page 114 of the Record.

II

Jurisdiction

(1) Jurisdiction is conferred upon this Court by Section 240(a) of the Judicial Code as amended by the

Act of Congress of February 13, 1925 (U. S. Code, Tit. 28, Sec. 347, 43 Stat. 938.)

(2) The date of the judgment to be reviewed is June 9, 1941 (R. 119). The petition for rehearing was denied July 11, 1941 (R. 124).

III

Statement of the Case

A statement of the case involved has been given under heading "Summary Statement of the Matter Involved" in the petition for a writ of certiorari, and, in the interest of brevity, is not here repeated.

IV

Specification of Errors

(1) The Circuit Court of Appeals erred in holding that losses on petitioner's transactions in refined oil should be treated as independent losses instead of as reducing petitioner's realizations on crude oil which the futures contracts for refined oil were purchased to replace.

(2) The Circuit Court of Appeals erred in not holding that losses and expenses incurred in petitioner's transactions in contracts for refined oil futures were not deductible as ordinary and necessary expenses of doing business pursuant to Section 23(a) of the Revenue Act of 1934.

(3) The Circuit Court of Appeals erred in holding that petitioner's losses in its dealings in contracts for refined oil futures were losses upon the sale or exchange

of capital assets, the deduction in respect of which was limited by Section 117 of the Revenue Act of 1934, instead of ordinary losses deductible to the full extent thereof pursuant to Section 23(f) of said Act.

(4) The Circuit Court of Appeals erred in reversing the decision of the Board of Tax Appeals.

V

Statutes Involved

Inasmuch as the taxable year is one ending on June 30, 1936, the statute primarily involved is the Revenue Act of 1934, C. 277, 48 Stat. 680. The pertinent parts thereof are shown below.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any tax payer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. (U. S. C., Title 26, Sec. 22.)

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise. (U .S. C., Title 26, Sec. 23.)

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(b) *Definition of Capital Assets.*— For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the in-

ventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * * (U. S. C., Title 26, Sec. 101.)

VI

Summary of the Argument

A

The petitioner's transactions in contracts for the delivery of refined oil were essentially a part of its process of marketing crude oil and, until such transactions were completed, it was not possible to determine whether a profit had been made, in fact, upon the manufacture and sale of the crude oil which these contracts were purchased to replace.

B

The expenses involved in the purchase and closing-out of contracts for the future delivery of refined oil, including losses sustained thereon, were ordinary and necessary expenses of engaging in the petitioner's business and were deductible to the full extent thereof.

C

The losses sustained by the petitioner in the purchase and closing-out of contracts for the future delivery of refined oil were not losses on the sale of capital assets and were deductible to the full extent thereof.

VII
ARGUMENT
A

The petitioner's transactions in contracts for the delivery of refined oil were essentially a part of its process of marketing crude oil and, until such transactions were completed, it was not possible to determine whether a profit had been made, in fact, upon the manufacture and sale of the crude oil which these contracts were purchased to replace.

The petitioner's case is based primarily upon the contention, which, it submits is abundantly sustained by the evidence, that its dealings in refined oil futures, in the year here involved, constituted an integral part of its business of manufacturing and selling cottonseed oil. The Board of Tax Appeals adopted that view in its opinion. It is submitted that the judgment of the court below can be sustained only if such dealings be treated as independent business ventures wholly unrelated to the crude oil marketing problem.

The Circuit Court of Appeals did not, in its opinion, deal, in terms, with all of the contentions made by the petitioner, but rested its conclusion primarily upon its holding that the transactions of petitioner in refined oil futures did not constitute hedges in the generally

accepted sense of that term and, accordingly, did not come within the decision of the Board of Tax Appeals in *Grote v. Commissioner*, 41 B. T. A. 247. That court did not deny that transactions in crude oil might not be hedged by compensating transactions in refined oil, but, on the contrary, adopted in its statement of the facts, a finding by the Board of Tax Appeals that there is a direct relationship between the market prices of refined oil and crude oil as of any given date. That transactions in refined oil futures are appropriate vehicles for hedging transactions in crude oil inevitably results from price relationship and from the great similarity between crude oil and refined oil, the latter merely being crude oil with impurities removed, and the process of manufacturing refined oil necessary involving the earlier production of crude oil. It is of the greatest significance here that, as an economic consequence of the direct relationship between the prices of the commodity in its two different stages of processing, transactions in the commodity at one stage may be offset by compensating transactions in it at the other stage, with no more than immaterial variation. Of importance also is the fact that cottonseed oil, both crude and refined, is obviously a fungible commodity.

There is a question whether income tax results should follow from a transaction in a fungible commodity in the event that there is a precisely compensating transaction in the same commodity. Recognition of gain or loss essentially requires an exchange of property for other property differing materially either in kind or extent. *Weiss v. Stern*, 265 U. S. 242, involves an appli-

cation of this doctrine. The decision of the court below in *Esperson v. Commissioner*, 49 F. (2d) 259, cert. den. 284 U. S. 658, may involve an application of this principle, and it seems to be the basis of the decisions of the Board of Tax Appeals in *Frank Kell*, 31 B. T. A. 212, issue 4, (in which the respondent has acquiesced, XIV-1 Cum. Bul. 11) and in *Fremont C. Peck et al, Executors*, 31 B. T. A. 87, (issue 2.) The petitioner however, recognizes that, notwithstanding the economic relationship which exists between the prices of cottonseed oil in its crude and refined states and permits the consumation of offsetting transactions, there are technical differences on the basis of which the facts here can be distinguished from the facts in the cases cited, and that these differences may make it probable that the decision, sub silentio, of the court below on this point is not so plainly in conflict with the decisions cited as to lead this Court to grant a petition for a writ of certiorari on this ground. Nevertheless, petitioner does not desire to waive its claims in respect of this legal proposition because it is only as a result of an adverse decision on this question that the other questions urged in the petition properly arise.

B

The expenses involved in the purchase and closing-out of contracts for the future delivery of refined oil, including losses sustained thereon, were ordinary and necessary expenses of engaging in the petitioner's business and were deductible to the full extent thereof.

As we have said, the court below did not deal, in terms, with this contention made by the petitioner ex-

cept as its discussion of hedges is such a dealing. The petitioner did not urge there that its transactions in refined oil futures constituted hedges in the generally accepted sense of that term and it does not make that argument here, although they appear to be called hedges in the trade. (R. 85, 102.) But it does not at all follow that the petitioner should not prevail, for losses incurred in hedges are not specifically allowed as deductions by the Revenue Act of 1934. The theory upon which they are allowed is that hedging is essential to conservative operations in certain businesses and constitutes a form of insurance; expenses and losses incurred therein are, accordingly, deductible as ordinary and necessary expenses of doing business. We urge here that petitioner's transactions in refined oil futures were an appropriate method of marketing, ultimately, the crude oil which business necessity forced it to dispose of at unsatisfactory prices, which might indeed involve losses, that expenses incurred in the marketing of products made by a manufacturer are ordinary and necessary expenses of its business and that the course pursued by the petitioner was the economic equivalent (with immaterial variations) of having its crude oil refined, stored for its account and subsequently sold. In the latter procedure, the petitioner would have paid a fee for refining its crude oil, charges for storage equivalent to rent and other expenses incidental to the sale of the refined oil thus held for its account. These expenses would be undoubtedly deductible as ordinary and necessary expenses of doing business—rental is specifically mentioned in Section 23(a) of the statute—and the sales price of the

refined oil would be the sales price of the petitioner's stock of goods. Cf. *Renziehausen v. Lucas*, 280 U. S. 387; *Roney v. Commissioner*, 67 F. (2) 165. Furthermore, this process was adopted to enable petitioner to crush more cottonseed and might properly be charged to the expense of that operation.

The decision of this case should not turn upon the narrow point that the petitioner adopted the course of selling the crude oil and offsetting such sales by the purchase of refined oil futures instead of having the crude oil refined for its account, particularly when the former process is the better adapted to produce the greater net income. That would involve too great an emphasis upon form as against substance. Such an emphasis is not consistent with *Gregory v. Helvering* 293 U. S. 465, *Helvering v. Tex-Penn Oil Co.*, 300 U. S. 481, or *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252.

Nor is it of consequence that the petitioner did not engage in this marketing process every year or at all times during this year. Cf. *Kornhauser v. United States*, 276 U. S., 145, and the comment thereon in *Welch v. Helvering*, 290 U. S. 111, 113-4.

The court below calls attention to the fact that the petitioner, in these transactions, merely exchanged its market risk from crude to refined. This the petitioner freely admits. But as the object of this transfer was to permit other crude oil to be manufactured and to market crude oil already manufactured to the greatest net advantage taking account of the necessity of the petitioner's continuance in business, its limited storage facilities and the possible deterioration of the crude oil, neither

the object nor the effect of the transfer of the risk was to engage in an essentially different business; but rather they were to continue the very business in which the petitioner was primarily engaged. It should necessarily follow that the expenses and losses then incurred should be treated as ordinary and necessary expenses of the business, for the "Federal income tax is aimed at net income determined from gross income less items such as necessary expenses incurred or capital consumed in earning it." *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. at page 254.

C

The losses sustained by the petitioner in the purchase and closing-out of contracts for the future delivery of refined oil were not losses on the sale of capital assets and were deductible to the full extent thereof.

The definition of the term "capital assets" in Section 117 excludes stock-in-trade of the taxpayer, other property of a kind which would properly be included in its inventory if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Losses realized upon the sale of assets so excluded are deductible in full under Section 23(f) of the Revenue Act of 1934. In its findings of fact the Board of Tax Appeals stated that the contracts for refined oil futures were neither stock-in-trade nor property held by the petitioner primarily for sale to customers in the ordinary course of its trade or business. (R. 38) These findings are adverted to by the court below in its opinion

but are not commented on otherwise nor made specifically the basis of the court's holding, except perhaps inferentially in the further statement that the petitioner was not a manufacturer of refined oil. Because the petitioner prevailed before the Board of Tax Appeals, there was no occasion for it to undertake to controvert these findings before the Circuit Court of Appeals, nor is there any occasion so to do in this court, except for the purpose of defending the decision of the Board of Tax Appeals on other grounds than that on which it was rested in the event its grounds are found to be untenable. Cf. *Helvering v. Gowran* 302 U. S. 238. The petitioner asserts that these findings are within the class of ultimate findings which are not binding on the appellate courts. *Helvering v. Tex-Penn Oil Co.*, 300 U. S. 481, 491. The subsidiary facts as to the relationship between crude and refined oil and the prices thereof, and the purpose and effect of the acquisition of refined oil futures contracts are not in dispute. It is submitted that the above mentioned conclusions drawn therefrom by the Board of Tax Appeals are erroneous, at least as to the status of the refined oil or the futures contracts therefor as stock-in-trade of the petitioner. The Board of Tax Appeals, however, did not undertake to pass upon the question whether the contracts for refined oil futures should be inventoried.

Decisions of this Court establish conclusively that the crude oil manufactured by the petitioner was part of its stock in trade. *Heiner v. Mellon* 304 U. S. 271, *Renziehausen v. Lucas*, supra. These cases are also authority for the proposition that if the petitioner had

had its crude oil refined and held for its account, the resulting refined oil would have been part of the stock-in-trade of the petitioner. The *Mellon* and *Roney* cases are authority for the proposition that an intangible warehouse receipt or certificate, or the commodity represented thereby, may constitute part of the stock-in-trade of the owner thereof or at least property of a character which should be included in the inventory if on hand at the close of the taxable year. *Rockford Malleable Iron Works*, 2 B. T. A. 817, in which the respondent has acquiesced, and G. C. M. 1582, Cum. Bul. VI-1, page 171, are to the same effect. The converse of this situation is presented in *United States v. Utah-Idaho Sugar Co.*, 96 F. (2d) 756 (cert. den. 305 U. S. 631) and *United States v. Amalgamated Sugar Co.*, 72 F. (2d) 755.

Essentially what the petitioner did in this case was to substitute for the fungible commodity, crude oil, which constituted part of its stock-in-trade and which should have been included in the inventory of the petitioner if on hand at the close of the taxable year, firm contracts for the purchase of refined oil, another fungible commodity derived in a process of further manufacture of the original crude oil, and so directly related in price as to be readily exchangeable therefor with appropriate price adjustments. To hold this process involved the final disposition of the original stock-in-trade and entry into a separate business of dealing in refined oil futures, or refined oil, in such manner as to constitute them or it, capital assets is to ignore the realities of the situation. Cf. *Helvering v. F. & R. Lazarus & Co.*,

supra, 308 U. S. 255. Such a contention, however, is the only one justifying the judgment of the court below, but is refuted by the fact that it is a practice generally, if not universally, engaged in by processors of cotton-seed oil who do not own their refining facilities. An adverse decision of this question will impose a serious hardship upon such manufacturers. The limitations on the amount of deductible losses from the sale or other disposition of capital assets have been carried forward into succeeding statutes. Applying the limitation to these manufacturers will result in their having to pay taxes upon gains in transactions of this character while they are denied deductions for losses although the transactions are in fact an integral part of their business. There appears to be no reason to suppose that Congress intended such an unjust result or one so burdensome upon those engaged in this business.

Respectfully submitted,

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